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STOCK "BUY-OUT" PLANS: SELECTION AND DRAFTING

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Stock "buy-out" plans, funded by life insurance, have long been popular as a way of overcoming difficulties that arise when a stockholder in a closely held corporation dies. But like other devices in the estate planning field, such plans need periodic reappraisal in the light of developments in the tax law. Because of their widespread use and the delicacy of their tax aspects, these plans have received a good deal of attention in legal periodicals.[1] This article has three aims: to present the current status of the tax aspects of such plans; to serve as a practical guide in the choice of the type of plan to use; and to suggest points to consider in the drafting of the plan selected.[2]

There are several reasons why this is a good time for lawyers and other business advisers to take a new look at the stock "buy-out" plan area. The 1954 Internal Revenue Code has been around long enough to have acquired some seasoning. Final income tax and estate tax regulations have been issued for those sections of the Code that are pertinent to the area. Moreover, the two year storm in the Tax Court and the Courts of Appeals over constructive dividends that for a time threatened the tax feasibility of the stock redemption type plan has now subsided.[3]

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[1] FRIEDMAN, BUY AND SELL AGREEMENTS: A REVIEW AND A NEW LOOK (N.Y. Univ. 15th Annual Institute on Federal Taxation, 1957) 1053; Strecker, *Corporate Buy-Sell Agreements: Tax Problems in Drafting*, 15 Wash. & Lee 18 (1958); Swados, *Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement*, 26 Ford. L. Rev. 189 (1957); Note, *The Use of Life Insurance to Fund Agreements Providing for Disposition of a Business Interest at Death*, 71 Harv. L. Rev. 687 (1958); and Wolf, *Primarily, The Tax Considerations In Making The Cross-Purchase Vs. Stock Redemption Decision: And The Present Muddle*, The Daily Record, Baltimore, December 16, 1957.

[2] This article is limited to the use of "buy-out" plans with a corporate business. Similar plans are used with partnerships. For discussion of those aspects of such plans that are peculiar to the partnership situation, see Samuels, *Funding Partnership Buy-and-Sell Agreements with Life Insurance*, 35 Taxes 857 (1957), and Note, 71 Harv. L. Rev. 687, 697-702 (1958).

[3] The storm began with the Casale case in September, 1956 [Oreste Casale, 26 TC 1020 (1956)], and ended in March, 1958 with the Tenth Circuit's

FEATURES OF THE TWO TYPES OF PLANS

Before discussing the nature and effect of these tax developments, it may be helpful to outline briefly the chief features of the two types of plans most commonly used. These two types are: (1) the "cross-purchase" plan, wherein each owner of stock purchases insurance on the lives of the other owners and agrees that the survivors will purchase with the insurance proceeds the stock interest of any deceased owner; and (2) the "stock redemption" plan, wherein the owners of stock and their corporation together agree that the corporation will purchase insurance on the lives of the owners and the corporation will redeem the stock interest of any deceased owner with the policy proceeds. One of the most difficult planning decisions for lawyers and business advisers is making the choice between these two types of plans.

To illustrate further the features of each type of plan,[4] let us assume a situation where A, B, and C own a business corporation with a net worth of $100,000; 1000 shares are outstanding, A owning 400 shares, B and C each owning 300 shares.

The cross-purchase plan would require for full funding $100,000 face amount of life insurance in six separate policies, each party to the agreement owning a policy on the life of the other two parties.[5] A, B, and C would enter into an agreement wherein each party would promise to pay the premiums on the policies he owns, and in the event of the death of either of the other parties would purchase stock of the decedent at a price to be determined under the agreement and it would be agreed that the estate would

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reversal of Sanders v. Fox, 253 F. 2d 855 (10th Cir., 1958). The rash of comments that appeared during the storm indicated the concern felt by the tax bar. See, Mannheimer and Friedman, *Stock-Retirement Agreements — The Prunier and Sanders Cases*, 35 Taxes 567 (1957); Sneed, *A Defense of the Tax Court's Result in Prunier and Casale*, 43 Cornell L. Q. 339 (1958); Levine, *More on Casale: Decision was wrong because there was no severance of corporate property*, 6 J. Taxation 289 (1957); Lawthers, *Prunier offers no threat to a sound insured buyout plan*, 7 J. Taxation 2 (1957); and Lawthers, *Prunier reversed: no income to stockholders from premiums paid by corporation*, 8 J. Taxation 12 (1958).

[4] A number of excellent sample agreements are available to the draftsman. See 1 RABKIN AND JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS (1957), Forms 3.75 to 3.78 (cross-purchase type agreements) and Forms 3.80 and 3.80A (stock redemption type agreements); CASNER, ESTATE PLANNING (2d ed. 1956) 774-791; and SHATTUCK AND FARR, AN ESTATE PLANNER'S HANDBOOK (2d ed. 1953) 60-78, Form X (p. 470), Form XI (p. 498).

[5] A would take out $15,000 of insurance on the life of B and $15,000 on the life of C. B would take out $20,000 on A and $15,000 on C. C would take out $20,000 on A and $15,000 on B.

sell the stock at such price. There are a number of possible methods for determining the selling price of the stock.[6] The agreement should include restrictions on the sale or other disposition of the stock during the lives of the parties.[7] There should be a provision giving the survivors a right to purchase those policies on their own lives owned by the decedent's estate; for instance, if A dies, owning policies on the lives of B and C, B and C should have a right to purchase these policies from A's estate. It is often advisable to have a trustee a party to the agreement, to hold the policies and the stock and to administer the agreement on the death of a party.[8] The usual tax consequences flowing from such a cross-purchase agreement are that the premium payments on the policies are not deductible by anyone, the insurance proceeds are not taxable to the survivors, whose tax basis for the stock they get from the decedent's estate is its cost to them, and the decedent's estate includes the stock owned at death at the value fixed by the agreement and also its unmatured policies on the survivors' lives at their current value.

In a stock redemption type plan, an agreement would be entered into by A, B, C and the corporation. The corporation would take out a $60,000 policy on the life of A, a $45,000 policy on the life of B, and a $45,000 policy on the life of C; that is, altogether $150,000 of insurance in three separate policies.[9] The corporation would be the owner of

[6] For a comprehensive discussion of the various pricing methods, See Forster, *Valuing a Business Interest for the Purpose of a Purchase and Sale Agreement*, 4 Stan. L. Rev. 325 (1952). One method that will often be satisfactory is to provide that the parties to the agreement periodically stipulate the value of the stock, along with a proviso that if no such stipulation has been made within a given period of time, the value should be determined by means of an independent appraisal. For such a clause, see CASNER, *op. cit., supra*, n. 4, 786. See also O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 Harv. L. Rev. 773, 806 (1952). Helms v. Duckworth, 249 F. 2d 482 (D.C. App. 1957) shows that there are dangers in an agreement that merely provides for periodic reappraisal by the parties without any provision as to the consequence of their failure to do so.

[7] Restrictions may sometimes involve difficulties under the state law rules on unlawful restraints on alienation; for full discussion, see O'Neal, *ibid.*, 777-785. The clause used in CASNER, *op. cit., supra*, n. 4, 779 ("Alternative 1") is a good way to handle the lifetime restriction.

[8] For the advantages of having a trustee and for suggested trust provisions, see SHATTUCK AND FARR, *loc. cit., supra*, n. 4. See also 1 RABKIN AND JOHNSON, *op. cit., supra*, n. 4, Forms 3.75, 3.76 and 3.78.

[9] The amounts indicated are approximate: mathematical precision is difficult and not practical, anyway, since the future value of the stock to be redeemed can only be estimated. The point to be noted is that an increased amount of insurance is necessary for full funding under the stock redemption type plan chiefly because the insurance proceeds — a corporate asset — increase the value of the stock to be redeemed. This problem is discussed further, *infra*, p. 282 and p. 285.

and the beneficiary under all the policies and would agree to pay all the premiums. The corporation would also agree that in the event of the death of a stockholder it would purchase his stock at a price to be determined under the agreement; and it would be agreed by the parties that the estate of the decedent stockholder would sell at such price. There should be restrictions on the sale or disposition of stock by the individual parties during their lives. On termination of the agreement, each individual party should have an option to purchase the policies on his own life owned by the corporation. The usual tax consequences flowing from such a stock redemption agreement are that premium payments on the policies are not deductible by anyone, the insurance proceeds are not income to the corporation, the estate of the decedent stockholder includes its stock at a price fixed under the agreement, the surviving stockholders' cost basis for their stock remains the same, and there is no dividend tax on either the decedent's estate or on the survivors.

These stock "buy-out" plans have been used extensively, and the life insurance companies have done a good job in educating the public on their advantages. But before such a plan is adopted it is important to make sure that it is right for the situation.[10] Perhaps the business should not be continued on the death of one of the active owners. A liquidation of the business, a sale of the business, or a merger with a larger firm may be the wisest plan.[11] Or, perhaps the principal stockholder wants his family to retain his interest, with a son taking over on his death.[12]

On the other hand, if the parties want to have their stock interest sold on their death, and if it is practical, businesswise, to have the survivors continue the business, then there are real advantages in a stock "buy-out" plan, both to the decedent stockholder's estate and to the sur-

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[10] See Tremayne, *Estate Planning for the Man with a Business*, 1955 Wash. Univ. L. Q. 40.

[11] See Hellerstein, *Mergers, Taxes and Realism*, 71 Harv. L. Rev. 254, 257 (1957).

[12] A recapitalization of the corporation, creating non-voting preferred stock for the non-active children of the principal stockholder, or the setting up of a trust to manage the business may be indicated. See CASNER, ESTATE PLANNING (2d ed. 1956), 776. §6166 of the INTERNAL REVENUE CODE, added by the "Small Business Tax Revision Act of 1958" (enacted September 2, 1958), 15 CCH St. Fed. Tax Rep. #37, ¶756 (Aug. 20, 1958) provides for spreading payment of the estate tax on close corporation stock over a ten-year period. This recent statutory change may stimulate more frequent use of arrangements other than the stock "buy-out" plan. It should be noted that this optional extension of the time of payment is not available where the decedent's stock interest is sold or redeemed under a "buy-out" plan [§6166(h)].

vivors.[13] The decedent stockholder's estate is assured that there will be cash available for the purchase of its stock at a price determined with a minimum of haggling and delay, and based on a going concern valuation rather than a liquidation valuation. Survivors acquire the decedent's stock for merely the cost of the premiums on the policies on his life and the possibility that a stranger or the family of the decedent stockholder will have to be accepted in the management of the business is avoided. The business gains greater stability; its relationships with its creditors and with its employees are improved.

ESTATE TAX VALUATION

Another advantage of stock "buy-out" plans is that they can fix the value of stock for estate tax purposes. Valuation of a stock interest in a close corporation is one of the most troublesome tasks faced by an executor and his lawyer. If the value of the estate's stock is fixed by such a plan, there will be one less headache in the administration of the estate. But to achieve such a result demands more than merely an agreement with a pricing formula.

On the basis of the final Estate Tax Regulations,[14] and the cases to date,[15] there is reasonable certainty that the valuation will be frozen by the agreement if (1) the agreement is a bona fide business arrangement, (2) the estate of the decedent is obligated to sell its stock at the price determined under the agreement and the survivors (the corporation in the case of a stock redemption type plan) are obligated to buy, or at least have an option to buy, at such price, and (3) the agreement contains a binding restriction against stockholders selling stock during their lives at a price higher than the agreement price, or otherwise disposing of stock without the consent of the other parties to the agreement.[16] Without these three characteristics, al-

[13] See Tremayne, *supra*, n. 10; SHATTUCK AND FARR, AN ESTATE PLANNER'S HANDBOOK (2d. ed. 1953) 70; and 1 BOWE, ESTATE PLANNING AND TAXATION (1957), 495-7.

[14] Treas. Reg. §20.2031-2(h) (1958), CCH Fed. Est. & Gift Tax Rep. #175, p. 36 (June 23, 1958).

[15] For discussion of the cases, see FRIEDMAN, BUY AND SELL AGREEMENTS: A REVIEW AND A NEW LOOK, (N.Y. Univ. 15th Ann. Inst. on Fed. Taxation, 1957) 1068-1077; Swados, *Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement*, 26 Ford. L. Rev. 189, 200-206 (1957), and Note, 71 Harv. L. Rev. 687, 690-695 (1958).

[16] In Baltimore National Bank v. United States, 136 F. Supp. 642, 654 (D.C. Md., 1955), Thomsen, C. J., thoroughly discusses the problem and concludes:

> "The present and proper rule is that the specified price is not controlling for estate tax purposes unless the restrictive provision (1)

though the agreement price will lose its conclusive effect, usually the plan will still have the effect of lowering in some degree the estate tax valuation.[17]

A comparison of the final version of the Estate Tax Regulations with the proposed version reveals a considerable modification in the Government's position (or at least in the outward manifestation of that position). The proposed Regulations[18] indicated that a right of first refusal in other parties to the agreement would not be a sufficient restriction on sale during life. In the final Regulations this reference to a first refusal restriction was deleted. Certainly where such right of first refusal is accompanied by a price-fixing provision it should be a sufficient restriction. In another change, instead of stating the requirement that there be "full and adequate consideration in money or money's worth" for *all* agreements, the less onerous phrase — "bona fide business arrangement" — was substituted, together with the warning that the agreement not be "a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth".

The most substantial change in the final version of the Regulations was the complete elimination of proposed Regulations Section 20.2042-1(c)(6). This paragraph had suggested that the agreement price under a stock redemption type plan would not be binding unless the proceeds of the insurance policies were reflected in the agreement price. Of course, the elimination of this requirement in the Regulations does not indicate the Government will no longer consider this aspect important; it merely indicates that it is not yet ready to take a firm position on the point.

Whenever the agreement price turns out to be much less than the value of a deceased stockholder's stock at his death, the bona fides of the agreement still will be questioned. And, of course, if a family-owned corporation is involved, there is the immediate suggestion that the agreement has been used to avoid an estate tax on what amounts to a bequest to the related surviving stockholders.[19] As the pro-

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prevents transfer of the shares during the holder's life at a figure higher than the specified price, and (2) grants an option to purchase, or requires a transfer, at that price on the shareholder's death."

[17] *Ibid.*, 655.

[18] Proposed Reg. §20.2031-2(h) (1956), 21 Fed. Reg. 7850.

[19] Even when the stockholders are not related and have bargained at arm's length, if it can be shown that they deliberately devised a price formula that would give the survivors stock worth more than the purchase price, it may be argued by the Government that the stockholders were in effect wagering on the order of their deaths. Generally a wagering gain is

posed Regulations indicated, a common way in which this disparity between price and value occurs is where the pricing formula under a stock redemption type agreement ignores the cash surrender value of the policies owned by the corporation under the plan and the proceeds of those policies maturing at the time the redemption is to take place. Thus, it is especially important that these elements of value be considered in the pricing formula whenever a binding estate tax valuation is sought and the corporation is family owned.

Frequently stock "buy-out" plans provide that the price should be the stipulated price or the amount of insurance proceeds on the decedent stockholder's life, whichever is higher. If upon the death of a stockholder the full insurance proceeds are paid to his estate for stock actually worth much less, certainly the Government will be happy to use the price paid for the stock as its estate tax valuation. Moreover, such a provision has little to recommend it as a matter of fairness between the stockholders.[20] A tax danger exists when such a provision is used in a stock redemption type plan, for it casts doubt on the legitimacy of the corporate investment in the policies. It seems odd that the corporation should agree to pay more to to a decedent stockholder's estate for its stock than its fair value.[21]

When a conventional stock "buy-out" plan is employed with all incidents of ownership as to the insurance policies

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ordinary income to the recipient. In reply, the taxpayer may argue that the survivors' benefits when they win on the wager are not yet realized since they are merely acquiring a stock interest at a bargain price and that taxing their gain must await the survivors' disposition of their stock. Bargain purchases, however, have been taxed at the time of purchase in other situations where the existence of the bargain was due to some income-producing factor, such as "compensation" in the case of an employee's bargain purchase; see Commissioner v. LoBue, 351 U. S. 243 (1956) or "dividend" in the case of a stockholder's bargain purchase, see Treas. Reg. 1-301-1(j) (1955). Here, the winning of the wager might be held to be a sufficient income-producing factor.

[20] Such a provision may have some utility when the parties want a low price on any *inter vivos* sale but a high price on death. For instance, the parties may want a low price on *inter vivos* sale both because it will discourage an owner from withdrawing from the business and because no funding will be available from the insurance to cover the purchase price, and yet they also may want the estate of any deceased stockholder to have the benefit of the increased value at death of the policies on his life. A low stipulated price with the proviso that at death the price will be no less than the insurance proceeds achieves in a rough way such objectives.

[21] The lower courts in the Prunier and Sanders cases (discussed, *infra*, pp. 296-298) were prejudiced against the taxpayer because of the use of such a pricing provision, and even though both cases were reversed, such a provision may have an adverse effect in the accumulated earnings tax area (*infra*, p. 290) and in the dividend treatment of redemption area (*infra*, p. 288).

in the proper persons, the decedent's estate will not be forced to include for estate tax purposes both the value of the stock interest and also the insurance proceeds to be used in its purchase. The "incidents of ownership" test in the 1954 Code, governing the taxability of insurance proceeds under the estate tax, has virtually eliminated this possibility — once thought to be a serious tax danger.[22]

FACTORS INVOLVED IN THE CHOICE OF A PLAN

Choosing the best type of plan for a given situation involves weighing a number of factors. A comparison of the respective tax brackets of the corporation and the individuals concerned is an important factor — one that is often neglected. Since in a cross-purchase agreement the individuals pay the premiums while in a stock redemption agreement the corporation pays the premiums, the type that is the cheaper tax-wise depends chiefly on the respective tax brackets of the corporation and the individuals. If the individual stockholders are not employees and thus can get money out of the corporation only by way of dividends, the stock redemption plan is the cheaper. If both the corporation and the stockholders are in the 52% bracket and the stockholders can readily take money out of the corporation by way of salaries, the tax cost of each plan would be approximately the same. If, however, the corporation is in a 52% bracket and the stockholders are in brackets lower than 52%, again assuming that the stockholders can get money out by way of salaries, the cross-purchase agreement would be the cheaper plan. Of course, some stockholders may be in high tax brackets while others are in low ones, and some stockholders may be employees and others not. In such cases there will be conflicts of interest between the stockholders as to the type of plan that should be used. Where stockholders can not withdraw cash out of their corporation by way of salaries or where they have individual tax brackets above 52%, the stock redemption plan generally achieves a much desired result; that is, it gets cash out of a closely held corporation without the payment of a "double tax" on the corporate earnings withdrawn.[23] This consideration may be what is chiefly responsible both for the popularity of the stock redemption type plan and for the Government's hostility to it.[24]

[22] For situations where the danger still exists, see Note, 71 Harv. L. Rev. 687, 694-5 (1958).

[23] *Ibid.*, 702.

[24] See discussion, *infra*, p. 292.

In several respects, the cross-purchase type plan is more favorable than the stock redemption type. In the first place, less insurance is required to fund fully a cross-purchase plan than a stock redemption plan. In fairness to the older stockholders, and to assure that the conventional tax consequences will apply,[25] the method for fixing the price of the stock of a decedent stockholder under a stock redemption plan should recognize the proceeds of the insurance on the decedent's life as an asset of the business on the date of his death. To take the most extreme situation, if the net worth of a business equally owned by A and B is $100,000, it would take $200,000 face amount of insurance owned by the corporation to fund the agreement fully.[26] Under a cross-purchase plan, on the other hand, a total of $100,000 face amount of insurance would be sufficient. The greater the number of individual stockholders involved in the plan, the less difference there will be in this respect between the two types of plans.[27] The cross-purchase plan has a further advantage over the stock redemption plan in that the cash surrender value of the insurance policies devoted to the plan will not be available to the business creditors in the event of the corporation's bankruptcy.

Another advantage of the cross-purchase type of plan is that the survivors obtain a tax basis for the decedent's stock interest equal to the price they pay for it, while under

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[25] See *supra*, p. 282.

[26] For the sake of simplicity, the cash surrender values of the insurance policies have been ignored. On this assumption, upon the maturity of the $100,000 policy on the decedent's life the total net worth of the corporation will increase from $100,000 to $200,000. Thus, to redeem the decedent's half interest in the corporation, $100,000 is required; and to fund the plan fully the corporation needs a $100,000 policy on each stockholder.

[27] To recognize this "pyramiding" of the amount of insurance required under a stock redemption plan involves serious practical problems. Often a small corporation will not have sufficient extra working capital to pay premiums on the amount of insurance theoretically required. The use of low cost term insurance is one way to keep down the cost of the plan. Another approach is to forego full funding of the plan. With partial funding, though the agreement price would reflect the increase in net worth arising from the maturity of the insurance, the agreement would provide for spreading over a period of years payment of so much of the price for the decedent's stock as exceeded the insurance proceeds available on his death. Another common practice is simply to ignore the increase in value resulting from the maturity of the insurance. This is unfair to the older stockholders since the value of the matured policy will then inure solely to the benefit of the survivors, even though the insurance premiums have been paid out of corporate funds equitably belonging to all the stockholders. The older stockholders may be willing to make this sacrifice so that the plan will be cheap enough to be feasible. See Note, 71 Harv. L. Rev. 687, 689 (1958). The deliberate setting of a low price, however, may create tax difficulties, particularly in the family-owned corporation situation. (See, *supra*, p. 282, and *infra*, n. 88.)

a stock redemption plan the survivors do not get any increase in the tax basis of their stock interest on the redemption of the decedent's stock by the corporation. To put the point more accurately, the insurance proceeds under a stock redemption plan will add value to the survivors' interest in the business, without any increase in the survivors' basis, while in the cross-purchase plan the insurance proceeds will be added to the survivors' tax basis in step with the increased value of their stock interest. This disadvantage of the stock redemption plan may be significant if some of the individuals involved are likely to sell out their interests during their lives. If a survivor does have to sell, however, the low tax basis will mean an extra tax at only capital gain rates. There is also the chance that such a tax may be avoided altogether by reason of his own death, which will give his estate a stepped-up basis for his stock.

On the other hand, in some respects, the stock redemption plan is the more favorable type. Psychologically, a stock redemption plan often seems more attractive to stockholders because the premiums do not come out of their own pockets. Even when, because of respective tax brackets, the cross-purchase type of plan may be less costly tax-wise, the stockholders often will be more concerned about avoiding a drain on their personal budgets. Furthermore, when the corporation is paying the premiums there is more certainty that the policies will stay in force. In a cross-purchase plan, there must be a continual check on the stockholders to make sure that each is keeping up his premium payments. Moreover, in a cross-purchase plan, the younger men own policies on the older ones, which means they pay higher premiums. This is fair all around since "actuarially" they are getting what they are paying for; the younger men, however, often have the feeling that they are paying more than they should and thus prefer a plan where the business pays all the premiums.

Despite its liberalization in the 1954 Code,[28] the transfer for value rule still favors the stock redemption type plan. Under a stock redemption plan, when a stockholder dies there is no need for a transfer of existing policies. Moreover, under the present version of the transfer for value rule, it is possible to put into effect a stock redemption plan using existing policies without any trouble from

[28] I.R.C. of 1954, §101(a)(2), the effect of which is to make the insurance proceeds taxable when the policy has been transferred for value.

this rule.[29] With respect to a cross-purchase type plan, however, existing policies can not be so exploited, and, because of the rule, when a stockholder dies it is not practical for a survivor to buy from the decedent's estate the policies the estate owns on the lives of the other survivors. Of course, in most cases, it will be possible for the survivors to purchase additional insurance, and the estate can either sell the policies it owns to the insureds or to the corporation, or else cash them in. It is when a survivor has become uninsurable that this transfer for value rule is most irksome, but even then there are ways to keep a "buy-out" plan in full effect.[30] Nevertheless, it would be a welcome legislative change if the exceptions to the transfer for value rule[31] were expanded so that policies could be transferred as freely between stockholders in a close corporation as they presently can between partners.

PROBLEMS PECULIAR TO STOCK REDEMPTION PLANS

The pros and cons already discussed are still less than the full picture needed to make an intelligent choice of the best type of plan for a given situation. There are a number of special problems peculiar to the stock redemption type of plan that should be examined.

In the first place, the workability of a stock redemption plan, and in some states even its validity, depends on whether the applicable corporation law permits such redemptions.[32] Although most states provide that a corporation may purchase its own shares only out of surplus,[33] this usually does not present serious difficulties. The insurance proceeds themselves will often produce sufficient surplus. Moreover, it is usually possible to produce sufficient surplus through a statutory reduction of capital.[34]

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[29] See FRIEDMAN, BUY AND SELL AGREEMENTS: A REVIEW AND A NEW LOOK (N.Y. Univ. 15th Ann. Inst. on Fed. Taxation, 1957) 1066.

[30] See 1 RABKIN AND JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS (1957) Form 3.78 for "sinking fund" provisions to protect the uninsurable stockholder. The conversion of a cross-purchase plan into a stock redemption plan may in some situations provide a solution to this difficulty.

[31] I.R.C. of 1954, §101(a)(2)(B).

[32] See O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 Harv. L. Rev. 773 (1952).

[33] See, *e.g.*, 2 MD. CODE (1957), Art. 23, §32(b)(3).

[34] See, *e.g.*, 2 MD. CODE (1957), Art. 23, §34 and §36(b). As to the use in Maryland of a statutory reduction of capital as a way out of such difficulties, see BRUNE, MARYLAND CORPORATION LAW AND PRACTICE, (Rev. ed., 1953), §49, *fn.* 14. See also Kraft v. Rochambeau Holding Co., 210 Md. 325, 123 A. 2d 287 (1956). See 1 RABKIN AND JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS (1957), Form 3.80A for a clause covering the problems of an insufficient surplus.

A more troublesome problem concerns the tax effect of the redemption on the estate of the decedent stockholder. Section 302 of the Internal Revenue Code of 1954, which seeks to separate redemptions to be treated as exchanges and redemptions to be treated as dividends, and Section 318, which provides rules on constructive ownership of stock, are both highly intricate provisions, added in the 1954 Code. They may present serious traps for the stock redemption type of plan, especially when a family-owned corporation is involved.[35]

The danger may be, perhaps, best explained through a series of hypotheticals. In a recent revenue ruling,[36] the Internal Revenue Service presented a situation which it ruled would result in a dividend to the estate of the decedent stockholder. In their example, A, the decedent, had owned 27% of the stock at his death, A's son owned 48%, and unrelated employees owned the remaining 25%. A's son was the sole beneficiary of A's estate. There was a stock redemption plan and on A's death the corporation redeemed from A's estate his 27% stock interest. Such redemption distribution, it was ruled, would constitute a dividend to the estate to the extent of the corporation's earnings and profits at the time (disregarding the partial relief that Section 303 might provide). Needless to say, such a result would be a very serious tax consequence to any estate. Section 302(b) sets out three independent tests, any one of which, if applicable, prevents a dividend result. The complete redemption test was not applicable because the estate of A was considered under Section 318(a)(2) to own the 48% stock interest of A's son since A's son was a beneficiary of the estate. The substantially disproportionate test was not applicable because after the redemption the estate still owned more than 50% of the common stock, since, again, the son's interest (66% of the stock outstanding after the redemption) was under Section 318(a)(2) considered constructively owned by A's estate. The gen-

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[35] See Hoffman, *1954 Code can turn buy-sell agreements into disastrous tax traps for stockholders*, 4 J. Taxation 322 (1956); Swados, *Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement*, 26 Ford. L. Rev. 189 (1957); Plowden-Wardlaw, *Constructive Ownership under the 1954 Internal Revenue Code*, 26 Ford. L. Rev. 441 (1957); Leon, *The Role of Constructive Ownership in Determining Whether a Stock Redemption is Taxed as a Dividend or a Capital Gain*, 51 Northwestern U. L. Rev. 568 (1956); and Winton and Hoffman, *A Case Study of Stock Redemptions under Sections 302 and 318 of the New Code*, 10 Tax. L. Rev. 363 (1955).

[36] Rev.-Rul. 56-103, 1956-1 Cum. Bull. 159.

eral test[37] — "not essentially equivalent to a dividend" — was not applicable, says the ruling, since "the relative stock interest of the principal shareholder [the son] has not been materially changed by the redemption . . . [and] the fact that the redemption is pursuant to a contract between the corporation and the decedent does not appear significant for this purpose".

Assume the same facts as presented in the above ruling except that A at his death owns 45%, A's son owns 10% and unrelated individuals own the remaining 45%. Here the redemption of A's estate's 45% interest would not result in a dividend because the disproportionate redemption test would be applicable. This is true because after the redemption A's estate would own constructively less than 50% of the stock left outstanding,[38] and because the "80% rule" definition of disproportionate would be satisfied.[39] On the other hand, if A's son dies first, and his father is the chief beneficiary of the son's estate, the redemption of the son's 10% interest would be a dividend to the son's estate, since it would still own 50% of the stock for A's stock would be deemed constructively owned by the son's estate. Now assume that A is not the chief beneficiary of his son's estate; the son leaves only a sailboat to his father and the remainder of his estate is to go to his own wife. Still, technically, neither the disproportionate redemption test nor the complete redemption test would be satisfied. The only reason, however, these tests would not be met is because of a very minor bequest by the son to his father. In such a situation, it would seem proper to hold that the redemption is not a dividend because "not essentially equivalent" to one. That is, where the arbitrary rules of constructive ownership in Section 318 lead to harsh results, the general test should be used to alleviate the difficulty.[40]

These few hypotheticals should indicate how complicated the application of Sections 302 and 318 can be; the variety of situations to which these sections may be applicable and the unresolved problems in interpreting them are enough to stagger even the most imperturbable tax

[37] Treas. Reg. §1.302-2(b) (1955) states with respect to the general test: "One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under Section 318(a)."

[38] I.R.C. 1954, §302(b)(2)(B).

[39] *Ibid*, §302(b)(2)(C). The "80% rule" demands that A's estate, after the redemption, own less than 44% of the voting stock (80% of 55% = 44%). After the redemption, A's estate would still own constructively the interest of A's son, but this interest would constitute only 18% of the voting stock then outstanding (10%/55% = 18%).

[40] Plowden-Wardlaw, *supra*, n. 35, 467.

lawyer.[41] Assuming that the complications of these sections can be mastered, still the use of a stock redemption plan with a family-owned corporation demands a virtually impossible feat of planning.[42] Not only must the stockholders' relationships with one another, their relative stock holdings, the wills and trusts of each, and the partnership and corporate affiliations of each be carefully investigated, but also the future picture as to all these factors must be reliably predicted. It should be pointed out, however, that Section 303 on redemptions to pay death taxes may sometimes get an estate out of the dividend problem that Sections 302 and 318 would otherwise produce. Yet, Section 303 is a somewhat unsatisfactory shield to rely on, since whether or not it can be used will depend on facts that are often difficult to predict, such as (1) the proportion of the decedent's total estate that will be represented by his stock interest and (2) the amount of the estate's death taxes and administration expenses. The conclusion seems clear: these 1954 Code sections treating redemptions as dividends create a very serious obstacle to the use of the stock redemption type plan with a family-owned corporation — so serious in fact that generally in such situations the cross-purchase plan should be the type used.[43]

Another special problem for the stock redemption type of plan concerns the accumulated earnings tax imposed by Section 531 of the 1954 Code.[44] This penalty tax is applicable when a corporation accumulates earnings beyond the "reasonable needs of the business." Sometimes under a stock redemption plan, a considerable part of the earnings of the business is devoted to the paying of premiums on policies owned by the corporation for use under the plan. Yet, so far, the penalty tax has been rather easily avoided.

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[41] See Winton and Hoffman, *supra*, n. 35, 380.

[42] It is the rule of §318(a)(2)(A) — stock owned by a beneficiary of an estate shall be considered as being owned by the estate — that provides the chief obstacle. The use of legal life estates or revocable trusts in the estate planning of stockholders whose stock is to be redeemed on their deaths may sometimes provide a means of escape from this rule; Hoffman, *supra*, n. 35, 327. Treas. Reg. §1-318-3 (1955) to the effect that a person shall no longer be considered a beneficiary after he has received all the property bequeathed to him may help in other situations, especially those where the bequest involved is a relatively small one and its distribution prior to the redemption is feasible. But see Swados, *supra*, n. 35, 214.

[43] See Swados, *supra*, n. 35, and Steinberg, *Funding Stock-Redemption Agreements with Life Insurance*, 35 Taxes 669 (1957). In Kehoe, *How to use insurance-funded buyout plans today; tax safety grows with new cases*, 8 J. Taxation 156, 159 (1958), it is suggested that it may be preferable where a family corporation is involved to wait and exploit §303 rather than to use any stock "buy-out" agreement.

[44] Formerly the well-known §102 of the 1939 CODE.

The taxpayer merely lists certain benefits the corporate entity receives from the plan. The benefits usually relied on are (1) the plan makes possible a continuity of harmonious management, (2) the possibility of selling to adverse interests is eliminated, (3) banks are assured that inexperienced stockholders will not disrupt management, and (4) the employees' morale is improved because their jobs become more secure.[45] The well-known *Emeloid* case[46] in 1951 is the leading case using this approach, although it involved whether the insurance investment was incurred for "business reasons" under the excess profits tax rather than the effect of the plan with respect to the accumulated earnings tax. Despite this distinction, the case has been heavily relied on in support of the conclusion that the accumulated earnings tax is not a serious obstacle to the stock redemption type of plan. There would seem to be, however, some forceful arguments that the corporate investment in a stock redemption plan does not constitute the retention of earnings for a "reasonable need of the business." For example, since the stockholders themselves can achieve the same objectives under a cross-purchase agreement, is it *reasonable* for the corporation to support the plan out of its own funds, particularly when a stock redemption plan involves the purchase of more insurance than would be required under a cross-purchase plan? Even though the entity may obtain some long-run benefits from the investment in the plan, it is *reasonable* for the corporation to devote a substantial part of its retained earnings to these somewhat remote and problematical needs?[47]

A recent case, *Pelton Steel Casting Co. v. Commissioner of Internal Revenue*,[48] may disturb the calm that has pre-

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[45] See Mannheimer and Friedman, *Stock-Retirement Agreements*, 28 Taxes 423, 425 (1950).

[46] Emeloid Co. v. Commissioner of Internal Revenue, 189 F. 2d 230 (3rd Cir., 1951).

[47] It is true that two Courts of Appeals (see the *Prunier* and *Sanders* cases discussed, *infra*, pp. 298-300) have recently rejected the Government's contention that the tax effect of a corporate expenditure should turn on whether it was of primary benefit to the entity or to its stockholders. But in these cases, the question was whether or not the expenditure constituted a constructive dividend — a result that would seem to require the disregard of the corporate entity. The basic theory of the accumulated earnings tax, however, rests on making this very distinction between interests of the entity and those of its stockholders. For an interesting analysis of the problems involved in separating the interests of the entity and its stockholders, see Sneed, *A Defense of the Tax Court's Result in Prunier and Casale*, 43 Cornell L. Q. 339 (1958).

[48] 251 F. 2d 278 (7th Cir., 1958), *cert. den.*, 356 U. S. 958 (1958); see Strecker, *Corporate Buy-Sell Agreements: Tax Problems in Drafting*, 15 Wash. and Lee L. Rev. 18, 41-42 (1958).

vailed in this area since *Emeloid*. In *Pelton*, a 20% owner desired to buy out the two other owners. The corporation used the earnings of four years plus a $500,000 loan to buy out this 80% interest. The court held that the redemption of 80% of the outstanding stock was not a reasonable need of the corporate entity, but rather suited the personal and business needs of its stockholders, and consequently the penalty tax was imposed. Of course, *Pelton* was an extreme situation,[49] but it may indicate a shift in the wind. As a practical matter, however, the accumulated earnings tax is usually not serious, particularly for the comparatively small corporation. The $100,000 minimum credit[50] now provided in the Code and the inherent difficulties in enforcing the penalty tax with its criterion of reasonableness are obstacles to any concerted attack on stock redemption plans on this ground.

THE CONSTRUCTIVE DIVIDEND ATTACK ON STOCK REDEMPTION PLANS

There is one more special problem with the stock redemption type of plan — the danger that either the premium payments or the redemption distributions will be treated as constructive dividends.[51] The Government's attempts to treat the premium payments as constructive dividends had initial success in the lower courts but later met rebuff in the Courts of Appeals. The protracted battle, however, has left enough permanent scars so that it seems important to review the cases at some length.

Before discussing the story of the Government's constructive dividend campaign, it seems appropriate to ex-

[49] No dividends were declared in 1946, the tax year in question, despite earnings of over $200,000. Moreover, a majority interest was redeemed. It seems hard to say that getting rid of 80% of the stockholders is a need of the corporate entity that is separate and distinct from the personal needs of the individual owners.

[50] The "Small Business Tax Revision Act of 1958", §205 (enacted September 2, 1958), 15 CCH St. Fed. Tax Rep. #37, ¶754 (Aug. 20, 1958) increased the minimum credit provided in §535(c) of the 1954 CODE from $60,000 to $100,000 for tax years ending after December 31, 1957.

[51] The term "constructive dividend" is difficult to define precisely. In its narrow sense, it means a dividend that is merely constructively received by the taxpayer. Constructive receipt is defined in the Regulations as follows: "Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time." [Treas. Reg. 1.451-2 (1957)]. But often the term "constructive dividend" is used in a broader, and looser, sense as meaning any corporate expenditure or distribution which is to be treated as a dividend, even though not formally declared to be such by the corporation. It is in this looser sense that the term is used in this article.

amine why the Government is so hostile to the stock redemption type plan. With a closely held corporation, one of the popular tax goals is to get cash out of the corporation into the hands of the stockholders and yet avoid paying a tax at the stockholders' high individual rates on the distribution. Achieving treatment of a distribution as a redemption under Section 302(a), with a tax at capital gain rates, rather than as a dividend, with a tax at ordinary rates, is generally considered successful tax planning. The conventional treatment of the redemption made under a stock redemption plan is even more advantageous, for the distribution of the corporate assets to the estate of a deceased stockholder results in getting cash out of the corporation without payment of any individual income tax. Dividend classification is avoided because the distribution normally is treated as a redemption terminating the deceased stockholder's interest under Section 302(b)(3); and capital gain tax is avoided because the estate's basis for the stock being redeemed is stepped up under Section 1014 to its value at death — which is typically the purchase price to be paid under the stock redemption agreement.

As long as we have a tax structure that levies a tax on corporate earnings distributed to a stockholder at his individual rates in addition to the corporate tax on these same earnings, the Government presumably will be upset by any plan such as the stock redemption plan that avoids the second individual tax.[52] And as long as the tax law treats the close corporation on the same basis as large public issue corporations, and, probably, as long as the structure bestows special treatment on capital gains and a stepped-up basis on death for appreciated assets owned by a decedent, the Government and the taxpayer are going to be involved in controversy in the corporate distribution area, and a satisfactory over-all solution seems impossible. All that can be hoped for in the immediate future is that the dividing line between what can be done and what can not be done in this area becomes a little clearer.

[52] There is no fundamental tax policy that demands a "double tax" be paid on business earnings, for a business can be organized as a partnership and even small corporations and their stockholders can now elect to have the corporate business treated tax-wise as a partnership under §§1371-1377, added by §64 of the "Technical Amendments Act of 1958" (enacted September 2, 1958), 15 CCH St. Fed. Tax Rep. #37, ¶649 (Aug. 20, 1958). What the stock redemption plan achieves, however, is something significantly different from the treatment accorded partnerships, since all partnership earnings are taxed at the individual owners' rates while the stock redemption plan permits owners of a small corporation to get business earnings after paying a tax at only the corporate rate even when their individual tax brackets exceed the corporate rate.

There is a further reason why the Government can legitimately be upset in this stock "buy-out" plan area. It is often difficult to decide whether the particular plan being used is a cross-purchase plan or a stock redemption plan. It may be possible for the stockholders to escape dividend taxation while the premium payments are being made on the theory that the plan is a stock redemption type plan and then upon the death of a stockholder have the survivors purchase the stock of the decedent with the proceeds, and avoid dividend taxation on the survivors on the ground that all along the plan was really a cross-purchase plan, limitations now foreclosing the taxation of the corporation's payment of the premiums as dividends. *Doran v. Commissioner of Internal Revenue*,[53] illustrates how the Government can be caught in just this predicament. There the corporation had six stockholders. Three of them, as "trustees," applied for policies on the lives of the six stockholders, proceeds to be paid to the trustees. Under a stockholders' agreement, the proceeds were to be distributed to the surviving stockholders to fund their purchase of the stock of any deceased stockholder. The application for the policies, however, indicated that the corporation was the real applicant. There were corporate minutes that referred to the "buy-out" plan, and all premiums on the policies were paid by the corporation and charged to surplus on the corporation's tax returns. While the premiums were being paid, "both the corporation and the stockholders treated the matter, taxwise, as if the corporation was the owner of the policies."[54] In other words, factually it was not clear whether the corporation was the owner of the policies or whether the individual stockholders were the owners; or, to be more precise, whether the three "trustees" were acting for the corporation or for the individual stockholders. One of the stockholders died, the proceeds were collected by the trustees, and then paid to the decedent's estate for its stock, which was transferred to the surviving stockholders. The Tax Court,[55] in *Thomas F. Doran*, held that the trustees received the proceeds as agents for the surviving stockholders, from a policy "owned" up till then by the corporation, and thus when the proceeds were distributed to the survivors they received a dividend. The Ninth Circuit reversed, holding that all along the trustees and not the corporation, were the owners of the policies,

[53] 246 F. 2d 934 (9th Cir., 1957).
[54] *Ibid.*, 937.
[55] 15 TCM 629 (1956).

and thus there was no dividend to the survivors when the proceeds were used for their benefit. The necessary implication from this holding was that the corporate premium payments were dividends to the stockholders when the payments were made; and the time for charging the stockholders with such dividends had passed.

The contrast between the way this court dealt with the ownership of the policy and the approach of the First Circuit in *Prunier v. Commissioner of Internal Revenue*,[56] indicates the type of difficulty that the Government faces. In both cases, there were vague corporate minutes that referred to the stock "buy-out" plan. In both cases, the corporation paid the premiums and charged the amounts against surplus on their corporate tax returns.[57] In both cases, the "buy-out" agreement was executed by the stockholders alone, and the policies were "legally" owned by the individual stockholders. Yet, the court in *Prunier* worked out "equitable" corporate ownership of the policies and refused to treat the premium payments as constructive dividends to the stockholders. On the other hand, the court in *Doran*, on similar facts, emphasized that "legally" the individuals and not the corporation were the owners of the policies and thus while the premium payments might have been dividends in the past, the present use of the policy proceeds by the survivors did not constitute a dividend to them. The Government might fairly complain that the courts in these two cases have let the taxpayer take advantage of the sloppiness with which their plans were executed instead of penalizing them for it. Thus, the Government must often face a difficult problem in classifying the type of plan being used. This difficulty, together with its theoretical objection to the stock redemption type plan, may supply the motivation behind the Government's campaign against the stock redemption type plan.

The Government's recent campaign began with the Tax Court decision in *Oreste Casale*.[58] There a 52 year old owner of 98% of the stock of a corporation caused his corporation to adopt a deferred compensation plan (providing a pension for him beginning at age 65) and at the same time had the

[56] 248 F. 2d 818 (1st Cir., 1957).

[57] As far as the corporation is concerned, its tax is the same whether the premiums are treated as dividends or as corporate investments; in neither case are the premiums deductible. Thus, the manner in which a close corporation treats the premium payments on its tax return should not be considered significant on the question of "ownership" of the policies. The terms of the policies themselves should, in general, be controlling.

[58] 26 TC 1020 (1956).

corporation purchase a $50,000 endowment policy designed to fund the deferred compensation plan. The Tax Court held that the $6,000 annual premium the corporation paid for the policy was a constructive dividend to the "98%" stockholder. The Tax Court considered that the "98%" stockholder received an immediate benefit from the policy, despite the fact it was still owned by the corporation. The court ignored the stipulated contingencies under which the corporation, or its creditors, would get advantage from the policy on the theory that these contingencies were illusory. Though the Tax Court decision in *Casale* did not involve a stock redemption plan, its emphasis on the benefit arising to the individual stockholder from the corporate expenditures for the insurance and its disregard of the entity of the closely held corporation caused concern that these ideas would be extended and applied to the stock redemption plan situation.[59]

This extension was not long in coming. A few months later, the District Court of Utah in *Sanders v. Fox*,[60] relied on *Casale* in holding that the premium payments made by a closely held corporation under a stock redemption plan were constructive dividends to the stockholders in proportion to their stock holdings. In 1949 through 1951, the tax years involved, Mr. and Mrs. Sanders owned most of the stock of a corporation; they, together with another member of their family, owned 93% of the stock in 1949, decreasing to 87% in 1951. An unrelated employee owned the balance of the stock. In 1949 the corporation and the four stockholders entered into a formal stock redemption agreement funded by life insurance on the life of each stockholder. The agreement provided that the corporation would pay the premiums, and would be the owner of the policies, but also provided that each stockholder had the right to designate the beneficiary of policies on his own life. The corporation agreed to purchase the stock of any decedent stockholder at the price determined under the agreement — which was the valuation periodically agreed on by the parties, or the amount of the insurance proceeds, whichever was the greater. No dividends had been paid to the stockholders during the years in review and the earned surplus of the corporation amounted to $140,000 in 1951.

[59] Lawthers, *Weakness in Casale decision; insolvency could destroy benefit to owner-employee*, 5 J. Taxation 342 (1956).

[60] 149 F. Supp. 942 (D.C. Utah, 1957); Taylor and Maier, *Sanders case again emphasizes care needed in agreements funded by insurance*, 7 J. Taxation 68 (1957).

The District Court was not clear as to the specific grounds for its holding that the premium payments on the policies constituted dividends to the stockholders in proportion to their stock holdings. It recognized that the agreement and the insurance were potentially beneficial to both the corporation and the stockholders, but stressed the benefit to the surviving stockholders whose proportionate interest in the business would be increased by the redemption of any decedent stockholder's stock. It noted the fact that the decedent's beneficiary would get the full proceeds, even though the stock interest was worth less. But the court put its emphasis on the fact that the corporation was family-owned, and trying to separate the benefit to the corporation and the benefit to the stockholders in such situations would be unrealistic.

A few days after the *Sanders* decision, the Tax Court decided the *Prunier* case.[61] There two brothers, Henry and Joseph, each owned half the stock of a corporation. In 1950, the tax year in question, $45,000 of insurance had been taken out on each brother; Joseph was the beneficiary of the policies on Henry's life and Henry was the beneficiary of the policies on Joseph's life. Ownership rights in most policies were shared jointly by the brothers, and, in some, the exclusive right to change the beneficiary was given to the brother who was named beneficiary. The corporation had no interest in the policies other than what might be implied from the fact that there appeared in corporate minutes an agreement executed by the two brothers in their individual capacities (to the effect that on the death of either of them the proceeds of the policies on the decedent's life should go to the corporation to be used to buy the stock interest of the decedent brother), and from the fact that the corporation paid the premiums on the policies. The brothers tentatively fixed a price for the stock of each somewhat above the amount of the proceeds that would be available at death. The Tax Court held, with three dissents, that the premiums paid by the corporation on the policies constituted dividends to the brothers.[62] In its narrowest sense, the holding was that the policies belonged to the stockholders and not to the corporation, and thus the premium payments represented constructive dividends to the individual stockholders.

[61] Henry E. Prunier, 28 TC 19 (1957) [Dec. 22,327, CCH Tax Ct. Reporter].

[62] Each brother was considered to have received dividends in the amount of the premiums paid on the policies on his own life.

The holding of the Tax Court was not as disturbing as some of the language used in the majority opinion. The opinion suggested that the arrangement of the brothers was not of benefit to the corporation but only to the brothers, based on the theory that the redemption of the stock of a deceased brother would benefit the survivor and not the corporation, in that no part of the proceeds could "enrich" the corporation since they all would go to the decedent's estate. The court also noted that the fact all the proceeds would go to the estate regardless of how much less the estate's stock interest might then be worth was further indication of a scheme to benefit the stockholders rather than the corporation. What worried the tax bar most of all was the possibility that the court had considered all stock redemption plans of no benefit to the corporation and thus that the decision would be applied to conventional plans as well as to ill-conceived, vague arrangements like the one in the *Prunier* case.[63]

Within less than a year after the Tax Court decision in *Prunier*, the Courts of Appeals had reversed all three of these cases. The Second Circuit's reversal of *Casale*[64] started the pendulum swinging back in the taxpayers' favor. The court stressed that the corporation's payment of the insurance premium was not an "immediate" benefit to the "98%" stockholder. In other words, the rule that income is not taxable until it is "realized" was applicable. To demonstrate that the stockholder had not yet received more than a tentative benefit, the court pointed out the rights that the corporation's creditors would have in the event of the insolvency of the business. The opinion was, perhaps, most significant in its denunciation of the Government's attempt to disregard the separate entity of the corporation, the court stating that to disregard the entity in this situation would mean that the Government could disregard it in every case where a corporation is owned or controlled by a single person, even though such corporation is actively engaged in a commercial enterprise.[65]

Then, the First Circuit in *Prunier*[66] reversed the Tax Court. The court adopted the taxpayer's contention that

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[63] See *supra*, n. 3.

[64] Casale v. Commissioner of Internal Revenue, 247 F. 2d 440 (2nd Cir., 1957), *cert.* not auth.

[65] The Second Circuit's decision in Casale is questioned in Sneed, *A Defense of the Tax Court's Result in Prunier and Casale*, 43 Cornell L. Q. 339 (1958).

[66] Prunier v. Commissioner of Internal Revenue, 248 F. 2d 818 (1st Cir., 1957), *cert.* not auth.

under Massachusetts law the corporation would have equitable rights in the policies legally owned by the two brothers. Once it assumed that the corporation had equitable rights in the policies, or at least in their proceeds, it quickly concluded that the case fell within the well-established rule that where the corporation is the owner and beneficiary of a policy of insurance on the life of a stockholder the payment of premiums does not constitute income to the insured stockholder, citing among other cases the Second Circuit's recent decision in *Casale*. Strangely, the Government in its brief did not attack the taxpayer's contention that the corporation under the facts of the case had an equitable interest in the policies nor did it question the significance of such an interest if it did exist.[67] Instead, the Government relied on a broader approach, which would be applicable to most stock redemption plans; namely, that the plan was primarily for the stockholders' benefit rather than the corporation's. As to this, the court first questioned the utility of drawing a distinction between corporate purpose and stockholder purpose, and then went on to quote the standard reasons used to explain why a stock redemption plan is for the corporation's benefit.[68] The court pointedly refused to comment on what might be the tax consequences of this ill-conceived plan when one of the brothers died.[69]

The Tenth Circuit's reversal of *Sanders*[70] added the final and perhaps most crushing blow to the Government's attempt to make the corporation's premium payments under a stock redemption plan constructive dividends to the stock-

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[67] Where, as in this case, two brothers own all the stock of a corporation, it seems questionable to recognize for tax purposes a distinct "equitable" interest of the corporate entity in policies legally owned by the brothers as individuals. (See *supra*, n. 57.) Even if an equitable right of the corporation in the *proceeds* of the insurance would be recognized under Massachusetts law, here the two brothers could at any time during their joint lives cancel the agreement and cash in the policies, free from any effective interference by either the corporation or its creditors. Thus, the Government had a strong argument that the premium payments were constructive dividends in that under the peculiar facts of the case the policies were owned by the individuals and not by the corporate entity. See Lawthers, *Prunier offers no threat to a sound insured buyout plan*, 7 J. Taxation 2 (1957).

[68] Prunier, *supra*, n. 66, 821.

[69] *Ibid.*, 822. The potential dangers include: (1) the inclusion of the insurance proceeds as well as the value of the business interest in a decedent brother's estate, and (2) a constructive dividend to the decedent's estate or to the surviving brother arising out of the redemption distribution.

[70] Sanders v. Fox, 253 F. 2d 855 (10th Cir., 1958), *cert.* not auth.

holders. In rejecting the Government's main contention, the court said:[71]

> "[T]he test of weighing the ultimate purposes to be served and the potential benefits, as has been done by some courts and as was done by the trial court in this case, is impractical."

While it recognized that the corporation was predominantly owned by members of one family, the court concluded that "the correct rule must limit the analysis to those benefits 'presently realized.' "[72] As did the First Circuit in *Prunier*, this court indicated that tax difficulties might arise later when one of the stockholders covered by the plan died.[73]

There are several conclusions to be drawn from the history of these three cases. First, the corporation's premium payments under a conventional stock redemption plan will not be constructive dividends because the individual stockholders have not "realized" any benefit at the time the payments are made.[74] Second, this rule will be applied even in the case of family-owned close corporations; that is, ownership within a family group will not be a sufficient reason for disregarding the separate entity of the corporation for the purpose of treating the corporate expenditure as a realization of income to the stockholders. The ultimate conclusion is that the Government's attack on stock redemption type plans on the ground that corporate premium payments constitute dividends has failed and is (or at least should be) at an end.

THE ATTACK SHIFTS TO THE REDEMPTION DISTRIBUTION

Recently, evidence has been accumulating that the Government has shifted its attack to a new front; namely, that the redemption distributions to the deceased stockholder's estate are constructive dividends to the surviving stock-

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[71] *Ibid.*, 860.

[72] *Ibid.*, 858-9.

[73] *Ibid.*, 861.

[74] Moreover, the extent of future benefit to any individual stockholder from the corporate investment in any given policy is at most conjectural. For the theoretical and practical difficulties in determining the amount of the constructive dividend to each stockholder, see Sneed, *A Defense of the Tax Court's Result in Prunier and Casale*, 43 Cornell L. Q. 339, 373, fn. 127 (1958).

holders.[75] Two recent cases, *Zipp*[76] and *Holsey*,[77] have been cited in support of the conjecture that the focus of the Government's constructive dividend attack has thus shifted.

In *Zipp*, the transactions were odd and highly confused. Though oversimplified, the facts were, in essence, that a father, who owned 48 out of 50 shares of a corporation, transferred 46 shares to his two sons and his remaining two shares to the corporation and received $93,782.50 from the corporation — this sum constituting virtually all the earnings and profits of the corporation. The two sons were charged with a dividend in the amount of the corporate cash distribution to their father, even though the father ended up with the cash and the sons ended up with a corporation with very little in the way of assets. The court interpreted the situation as one where the sons had caused the corporate cash to be distributed for their individual benefit.[78]

In *Holsey*, Holsey owned half the stock of a corporation (the H Corporation), and also owned an option to purchase the other half of the stock for $80,000 from the G Corporation, which was controlled by Holsey's father. This option was made assignable to the H Corporation. In 1951, when the net worth of the H Corporation was $325,000, Holsey assigned his option to the H Corporation, which then exercised the option, distributing $80,000 to the G Corporation for its H Corporation stock. Holsey thus became sole owner of the H Corporation, now worth $245,000. That is, before the exercise of the option, Holsey's stock interest was worth

[75] See Hobbet, *The New Attack on Stock Redemptions*, 35 Taxes 830 (1957); Lawthers, *IRS continuing attack on insured redemptions despite court setbacks; Sanders reversed*, 8 J. Taxation 322 (1958); Jones, *How Stock Redemptions Produce Dividend Income*, 36 Taxes 437 (1958); and Note, *Stock Redemptions in Close Corporations: A Plan for Taxation*, 67 Yale L. J. 112 (1957).

[76] Zipp v. Comm'r of Int. Rev., 259 F. 2d 119 (6th Cir., 1958), aff'g. 28 TC 314 (1957) [Dec. 22,358, CCH Tax Ct. Reporter]. Note, *Zipp affirmed: successor stockholder taxed on constructive dividend*, 9 J. Taxation 39 (1958).

[77] Joseph R. Holsey, 28 TC 962 (1957) [Dec. 22,522, CCH Tax Ct. Reporter], on appeal to 3rd Circuit.

[78] As between the father and his sons, it might have been fairer to charge the father with the dividend, treating the simultaneous transfer of the virtually valueless stock to the sons as either a gift or a sale. The mixed up plan that was used, where the sons got the stock but the corporation paid the purchase price, made the situation a hopeless one for the taxpayers. *Cf.* Zenz v. Quinlivan, 213 F. 2d 914 (6th Cir., 1954) in which the redemption technique was successfully used in a purchase of the stock of a close corporation. The Government has accepted the decision, Rev.-Rul. 54-458, 1954-2 Cum. Bull. 167. With the enactment of §§302 and 318 of the I.R.C. of 1954, however, it is doubtful that the redemption technique can still be successfully used in a fact situation similar to Zipp — to get cash to the father and shift ownership of the business to the sons.

$162,500, while after the exercise of this valuable option, his stock interest was worth $245,000 (an increase in value of $82,500). The Tax Court held that Holsey received as a result of the redemption a constructive dividend of $80,000.

In its opinion, the Tax Court first referred to the line of cases holding that when a stockholder's personal obligation to purchase stock is discharged through a corporate redemption of the stock the stockholder receives a dividend. But here Holsey did not have a personal obligation to purchase the outstanding half interest; he merely had an option.[79] Recognizing this difficulty, the Tax Court then shifted to the "benefit" and "net effect" tests; concluding that the redemption was primarily for Holsey's personal benefit and the "net effect" of the transaction was a dividend to him in the amount distributed to the G Corporation in redemption of its H Corporation stock. The Tax Court's discussion of benefit and its weighing of the respective benefits flowing to the entity and to the individual stockholder is the same basic approach it used in the *Casale* and *Prunier* cases and that the District Court used in *Sanders*. *Holsey* has been appealed to the Third Circuit. In view of the fate of *Casale*, *Prunier* and *Sanders* in the Courts of Appeals, where the weighing of benefits approach was clearly rejected, it seems unlikely that the Third Circuit[80] will affirm the Tax Court; and if it does affirm, it probably will not use the Tax Court's benefit theory.[81]

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[79] The Tax Court recognized that its decision was basically *contra* to the Eighth Circuit's holding in Tucker v. Commissioner of Internal Revenue, 226 F. 2d 177 (1955), and expressly declined to follow it. Moreover, the facts in Tucker presented a situation easier to tax on the discharge of personal obligation theory than that in Holsey. The Eighth Circuit, however, refused to look through the complicated form of the transaction in Tucker and thus failed to recognize the force of the discharge of personal obligation argument in that case.

[80] The Third Circuit is the circuit that decided Emeloid Co. v. Commissioner, discussed, *supra*, n. 46, which makes it especially unlikely that it will go along with the Tax Court's "personal benefit" theory.

[81] There are three other routes that might be used to reach the result reached by the Tax Court: (1) the theory of Comm'r. v. Court Holding Co., 324 U. S. 331 (1945), that once a transaction is started it is too late to shift the form of the transaction to minimize the tax consequences; (2) the theory that Holsey's gratuitous assignment of the option to the corporation was a sham and should be ignored for tax purposes; or (3) the theory of Commissioner v. LoBue, 351 U. S. 243 (1956), that the exercise of the option resulted in a benefit in the form of compensation to Holsey from the grantor of the valuable option, the G Corporation, of which Holsey was a director. See Hobbet, *supra*, n. 75.

Supplemental Note: After this article was written, the Third Circuit reversed the Tax Court, Joseph R. Holsey, 58-2 USTC ¶9816 (3rd Cir., 1958). The court recognized that Holsey was indirectly benefited by the redemption "since the redemption was for less than book value and he

Can the Government successfully apply the theories underlying the *Zipp* and *Holsey* cases to the conventional stock redemption plan? When a stockholder dies, there clearly is a distribution of corporate assets.[82] But the major difficulty with the Government's position is its attempt to tax this distribution to the surviving stockholders, who are not the persons who receive the redemption distribution. The Government seeks to overcome this problem, or at least it did in *Holsey*, by claiming that the redemption distribution is really for the benefit of the surviving stockholders. But it just is not true that the survivors are benefited to the extent of the redemption distribution. Assume X and Y each own one-half of a corporation. X dies and the corporation purchases X's shares for a price equal to half of the net worth of the corporation. Value-wise, Y, the survivor, is not benefited. Treating the corporate net worth as equivalent to an apple, the change in Y's position is from owning one-half of an apple to owning all of an apple half as big. This is a change but not a gain. It has been contended, however, that the increased control over the corporation that the surviving stockholders acquire by reason of the stock redemption is a sufficient benefit on which to base a tax.[83] The difficulty with treating this increased control as a taxable benefit to the survivors lies in valuing such a benefit in monetary terms. Moreover, even assuming a situation where there is a benefit measurable in dollars inuring to the survivors, such as where the redemption price is lower than the true value of the stock redeemed, taxing such a benefit at the time of the redemption runs counter to the rule that gain must be "realized" before it can be taxed. The benefit to the survivors is still

became sole stockholder", but it reversed the Tax Court because such benefits were not yet "realized" and thus not presently taxable. One judge dissented on the theory that the assignment of the option to the corporation was a "sham". The majority, however, sidestepped the "sham" theory on the ground that the Tax Court had made no explicit finding that the assignment of the option was a sham.

On October 30, 1958, in Technical Information Release No. 109, 58 CCH ¶ 6780, the Internal Revenue Service announced that it would follow the 3rd Circuit decision in Holsey. The following paragraph of the release seems particularly significant:

> "In the future, IRS stated it will not treat the purchase by a corporation of one shareholder's stock as a dividend to the remaining shareholders merely because their percentage interests in the corporation are increased."

[82] In this respect the Government is in a better position than it was in trying to treat the premium payments as a constructive dividend (See *supra*, p. 300).

[83] Note, 67 Yale L. J. 112 (1957).

in the form of an appreciation in the value of their stock interest.[84]

Another proposition that seems to underlie the Tax Court decision in *Holsey* is that when a corporation redeems a deceased stockholder's stock the net effect of the transaction is the same as if the survivors had received dividends and used them to purchase the stock, and that, consequently, a corporate redemption should be treated in the same way that a dividend plus survivors' purchase would be.[85] Taxing the survivors on such a theory would violate the generally recognized principle that when a taxpayer has two ways to achieve a result he can use that method that will minimize his taxes, at least where both ways are statutorily recognized as legitimate. This "rough road is the only right road" argument seems particularly inappropriate here, now that the 1954 Code has considerably expanded the dividend treatment of redemption distributions to the recipients (the effect of Section 302 in conjunction with Section 318).[86] Where Congress has charted a comprehensive scheme to tax redemption distributions as dividends to the recipients in certain situations, a scheme devised with closely held family corporations clearly in mind, it would seem to flout legislative intent to improvise judicially a scheme to tax the surviving stockholders in such situations. It seems a reasonably safe conclusion that the conventional stock redemption plan has little to fear from the Government's latest constructive dividend theory.

So far, then, the Government has not successfully applied either of its constructive dividend approaches to a conventional stock redemption plan. Nevertheless, these recent cases contain warnings that anyone contemplating a stock redemption type plan should take to heart; namely, (1) the corporation should have all the incidents of ownership in the policies, (2) the price for the stock interest to be redeemed should be determined by a method that is calculated to produce a figure that is reasonably close to its true value at that time, (3) there should be no attempt to insulate the policies from corporate creditors, and (4) any family corporation situation is especially delicate.[87]

[84] In Sanders v. Fox, 253 F. 2d 855, 859 (10th Cir., 1958), *cert.* not auth., the court pointed out that realization "has never been held to include simple appreciation of stock value whether caused by internal corporate-stockholder buy-out agreements or ordinary corporate prosperity."

[85] Hobbet, *The New Attack on Stock Redemption*, 35 Taxes 830, 837 (1957).

[86] *Ibid.*, 841.

[87] See Note, 71 Harv. L. Rev. 687, 706 (1958).

It is true that the ignoring of one or more of these warnings may not result in constructive dividends being assessed; such is the teaching of the recent decisions in the Courts of Appeals. But good planning usually requires avoidance of litigation[88] and not just ultimate success. Moreover, the indiscriminate or inept use of the stock redemption type plan may, as we have seen, involve tax dangers much more serious than the constructive dividend theories now are.[89]

CONCLUSION

In conclusion, is it possible to set out any guides on the choice of the best type of stock "buy-out" plan for a given situation? A stock redemption type plan is clearly appropriate where: (1) the stockholders are in higher tax brackets than the corporation, or it is impractical for them to get more money out of the corporation by way of salaries, (2) there are no serious "accumulated earnings" tax problems now or in the forseeable future, (3) there are more than three stockholders in the picture, (4) stock redemption is feasible under the applicable corporation law, and (5) the corporation is not family-owned. On the other hand, if all five of the above factors are adverse, then a cross-purchase plan would be the type indicated. As to situations in between, when some factors point one way and others the other way (unfortunately most situations), the choice of the type of plan depends on a careful analysis of the facts and assessment of the applicable law and a delicate weighing of the factors pro and con. Therefore, it is difficult to state any general conclusion as to the best type of plan; but perhaps the following observations are appropriate: the tendency to use a stock redemption plan merely because it is simpler to establish and easier to "sell" to the parties should be restrained; the advantages of the cross-purchase type of agreement should be given full consideration; and, above all, in the initial decision as to whether or not to have any stock "buy-out" plan and in any choice as to type of plan, the many factors involved should be carefully canvassed before action is taken.

[88] Lawthers, *IRS continuing attack on insured redemptions despite court set-backs; Sanders reversed*, 8 J. Taxation 322, 325 (1958) concludes: "[T]he cases [the Government] will be willing to litigate will involve corporations controlled by one individual or a family, or those involving unusual procedures or circumstances."

[89] The agreement may be attacked at the time of the estate tax valuation of a decedent's stock (see *supra*, p. 281, *et seq.*); or §§302 and 318 may entrap the estate of a decedent stockholder in a dividend problem (see *supra*, p. 288, *et seq.*).